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IN THE

Supreme Court of the United States

October Term, 1968

No. 1375

WOLF CORPORATION, JOSEPH WOLF, JOSEPH ECKHAUS, LEON SPILKY, DAVID BERDON & CO., ~~and TROSTER, SINGER & CO.~~,

Petitioners,

—against—

LEON GREEN,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Dated: May 8, 1969.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

No.

WOLF CORPORATION, JOSEPH WOLF, JOSEPH ECKHAUS, LEON SPILKY, DAVID BERDON & Co., and TROSTER, SINGER & Co.,

Petitioners,

—against—

LEON GREEN,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners pray that a writ of certiorari issue to review the order of the United States Court of Appeals for the Second Circuit, entered December 9, 1968, which reversed an order of the United States District Court for the Southern District of New York dismissing the action insofar as it purported to be brought for the benefit of a class.

Opinions Below

The opinion of the Court of Appeals for the Second Circuit was filed on December 9, 1968. It is officially reported

at 406 F. 2d 291 and is reprinted in Appendix A hereto. The opinion of the District Court, filed on February 21, 1968, has not been officially reported. It is reprinted in Appendix B hereto.

Jurisdiction

This Court has jurisdiction under 28 U. S. C. § 1254(1) Petitioners time to file this petition has been extended to May 8, 1969 by order of this Court dated February 26, 1969.

Questions Presented

Did the Court below, by overlooking the conflicts of interests between the plaintiff and substantial numbers of the persons he claims to represent and by assuming that the Court could later provide for such conflicting interests by creating subclasses, err in applying Rule 23 of the Federal Rules of Civil Procedure, and does that error warrant this Court's review and correction?

A. Can the district courts, as the Court below assumed, on their own initiative adequately protect the interests of unrepresented persons having interests conflicting with those of the plaintiff?

B. Does Rule 23 make it proper for courts to cause solicitations to be made of allegedly aggrieved persons whom a plaintiff claims to represent but whom he cannot represent because of conflicting interests, and is the decision of the Court below predicated on the assumption that by such solicitations, and the suitors who might present themselves in response, conflicts with the class purportedly represented by the plaintiff can adequately be reconciled and appropriate subclasses formed?

Statutes, Rules and Regulations Involved

Rule 23, Federal Rules of Civil Procedure

(*a*) *Prerequisites to a Class Action.* One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that the joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

(*b*) *Class Actions Maintainable.* An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

* * *

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

(c) Determination by Order Whether Class Action to be Maintained; Notice; Judgment; Actions Conducted Partially as Class Actions.

(1) As soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained. An order under this subdivision may be conditional, and may be altered or amended before the decision on the merits.

* * *

(4) When appropriate (A) an action may be brought or maintained as a class action with respect to particular issues, or (B) a class may be divided into subclasses and each subclass treated as a class, and the provisions of this rule shall then be construed and applied accordingly.

* * *

(*d*) *Orders in Conduct of Actions.* In the conduct of actions to which this rule applies, the court may make appropriate orders: (1) determining the course of proceedings or prescribing measures to prevent undue repetition or complications in the presentation of evidence or argument; (2) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct to some or all of the members of any step in the action, or of the proposed extent of the judgment, or of the opportunity of members to signify if they consider the representation fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action; (3) imposing conditions on the representative parties or on intervenors; (4) requiring that the pleadings be amended to eliminate therefrom allegations as to representation of absent

persons, and that the action proceed accordingly; (5) dealing with similar procedural matters. The orders may be combined with an order under Rule 16, and may be altered or amended as may be desirable from time to time.

* * *

Section 10(b), Securities Exchange Act of 1934 (15 U. S. C. § 78j):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, Securities Exchange Act of 1934, General Rules and Regulations (17 C. F. R. § 240.10b-5).

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to

make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Statement of the Case

Defendant Wolf Corporation ("Wolf") became a public corporation on June 2, 1961, when, pursuant to a registration statement duly filed with the Securities & Exchange Commission (SEC), it issued 60,000 shares of its Class A common stock to the public at the price of $10 per share, and exchanged 746,350 shares of such stock and subordinated debentures of an aggregate face value of $2,808,000 for partnership interests in nine real estate syndicates (22a, Ex. 1).* The prospectus issued in connection with the registration statement shall hereafter be referred to as the "first prospectus."

On January 26, 1962, some six months after its initial public offering, Wolf filed with the SEC a second registration statement and, in connection with the registration statement, a preliminary prospectus (hereafter "the second prospectus") (Ex. 2). On June 1, 1962, Wolf filed an amendment to the registration statement and, in connection therewith, another preliminary prospectus (hereinafter "the third prospectus") (Ex. 3).

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*References to the supplementary appendix printed by Petitioners Wolf et. al in the Court of Appeals are preceded by "S" and references to the appendix printed by Respondent Green are followed by "a." Citations to exhibit numbers refer to exhibits annexed to Respondent's affidavits submitted in opposition to Petitioners' motion in the District Court and which are part of the record transmitted by the Court of Appeals to this Court. The affidavits themselves, without exhibits, were reprinted at pages 21-44 and 53-60 of Respondent Green's Appendix filed with the Court of Appeals.

Neither the second registration statement, originally or as amended, nor the second or third prospectus, became effective. No securities could be, or were, sold pursuant thereto.

On July 13, 1962, the SEC began an investigation concerning allegedly untrue statements in the second registration statement as amended. "Stop-order" proceedings were thereafter commenced, and were terminated by a stipulation resulting in an order dated May 4, 1966 which recited certain alleged deficiencies in the registration statement and which permitted Wolf to withdraw the registration statement and the preliminary prospectuses accompanying it (the second and third prospectuses), upon condition that Wolf provide its stockholders and all those who received those prospectuses with appropriate notice of the "stop-order" proceedings and of their termination (Ex. 4-6).

On December 15, 1966, after approval by the SEC, Wolf sent the requisite notice to its shareholders, and the second registration statement, and the second and third prospectuses, were permitted by the SEC to be withdrawn (75a).

Despite the notice provided by Wolf to holders of its securities, Plaintiff was the only shareholder of Wolf who brought suit. Plaintiff became a shareholder of Wolf on June 13, 1962 when he purchased 100 shares of Wolf's common stock for $1,042.25 ($10.25 per share plus commissions). Plaintiff made his purchase in the over-the-counter market after the filing of the third prospectus and more than one year after the public offering by Wolf of its securities pursuant to the first prospectus. Plaintiff alleges that he remains the holder of the 100 shares he purchased (42a).*

*Although the complaint alleges other purchases and sales by plaintiff of Wolf securities (5a-6a), plaintiff's counsel conceded below that his purchase of 100 shares of Wolf stock on June 13, 1962 is the sole basis for his suit (App. A p. 5).

Plaintiff claims that the first prospectus (issued more than a year prior to the time he purchased his shares), the second prospectus and the third prospectus were all deliberately false and misleading, and that as a result he and some 2,200 other purchasers of Wolf securities whom he claims to represent paid an artificially inflated price for their shares (4a-5a; 9a-10a). He seeks a recovery on behalf of this alleged class under section 10b of the Securities Exchange Act and Rule 23 of the Federal Rules of Civil Procedure (4a-5a).

Plaintiff alleges that Wolf, its principal officers (the individual defendants), the public accountants who audited its books (David Berdon & Co.) and the proposed underwriter of its second registration statement as amended (Troster, Singer & Co.) were guilty of material misstatements and omissions in the three prospectuses, and that the market price of the shares purchased by the plaintiff was thereby inflated (4a-5a).*

Plaintiff brings this action for himself and for all others "similarly situated" (9a). He defines those similarly situated as all persons who purchased for a monetary consideration the common stock of Wolf or the subordinated debentures of Wolf, between June 2, 1961 and the end of 1963, either pursuant to the registration statement which became effective on June 2, 1961 or in the open market during the two-and-a half years thereafter, and as to those persons who still hold Wolf's securities and as to those who sold such securities (9a, 21a).

Plaintiff alleges that the material misstatements and omissions which allegedly inflated the price he paid for 100 shares of Wolf stock in June 1962 (presumably those he claims were made in the third prospectus), were substantially the same material misstatements and omissions as those he claims were made in the first prospectus issued by

*Troster, Singer is charged with being involved in only the third prospectus (43a).

Wolf June 2, 1961 and as those he claims were made in the second prospectus issued January 26, 1962 (41a). As to persons who purchased Wolf stock during the year and a half following plaintiff's purchase, in whose right plaintiff also purports to sue, plaintiff alleges that the price of Wolf's stock continued to be inflated by the alleged material misstatements and omissions in the third prospectus (21a-22a). Plaintiff claims that because of alleged common misrepresentations in the three prospectuses, he can represent all persons who purchased the stock or debentures of Wolf between June 2, 1961 and the end of 1963 (21a-41a).

The group plaintiff claims to represent numbers some 2,200 people (14a). They can be classified by the following categories:

1. All persons, such as plaintiff, who purchased Wolf's securities reasonably after the third prospectus, filed June 1, 1962.

2. All persons who purchased Wolf's securities reasonably after the second prospectus, filed January 26, 1962.

3. All persons who purchased Wolf's securities reasonably after the first prospectus, pursuant to which the public offering of Wolf securities was made in June, 1961.

4. All persons who purchased Wolf's Securities from a time reasonably after the third prospectus until the end of 1963 when the charges made by the SEC in its "stop-order" proceedings became widely known to the public.*

---

*Petitioners pointed out in their briefs below that although plaintiff alleges that by the end of 1963 the alleged misstatements and omissions had become widely known through publicity concerning the SEC "stop-order" proceedings and the effects of such misstatements and omissions had become dissipated, the existence of the SEC "stop-order" proceedings was the subject of earlier news comment, as early as July 1962 (Supp. Br. in Ct. Ap., p. 2).

5. With respect to all of the groupings mentioned above:

(a) All persons who sold the securities they had purchased before the alleged misstatements and omissions became known and, therefore, while the price of such securities continued to reflect in whole or in part an artificially inflated value.

(b) All persons who sold the securities they had purchased after the alleged misstatements and omissions became known; and

(c) All persons who continue to hold the securities they had purchased.

6. With respect to all of the groupings mentioned above:

(a) All persons who purchased debentures and

(b) All persons who purchased common stock.

By attempting to represent such diverse groupings of persons, plaintiff has placed himself in a position where his interests will, in all likelihood, seriously conflict with those who purchased their securities at different periods of time and in connection with different prospectuses, with those who no longer have any security interest in Wolf, and with those who are holders of debentures. We discuss these conflicting interests in Point 1 below.

Plaintiff's counsel admitted on deposition that most of the alleged misstatements and omissions were not, contrary to the allegations of his complaint, common to the three prospectuses (S 1-5). Of the 16 claimed misstatements and omissions, plaintiff concedes that 10 are not common to the three prospectuses, and that of these 10, 6 were made only in the third prospectus (thereby affecting his subgroup alone) (S 1-5; see also our chart at pp. 5-7 of our

brief to the Court of Appeals). We discuss the implications of the substantial lack of commonality also in Point 1 below.

The Decisions of the Courts below.

The District Court (per Judge Sylvester J. Ryan) held that plaintiff failed to show common questions of law or fact and was not an adequate representative of the class he claimed to represent. The District Court stated:

> We find that the "class" purported to be represented by plaintiff in this action is by the allegations of the complaint (if, indeed, it can be said that there be any class who has a Section 10b claim under the facts alleged) not one class but two or more; and that the plaintiff cannot be held to be representative of any of these possible groupings of possible plaintiffs (App. B-3).

The District Court expressed concern that the federal courts might, if plaintiff's theory were upheld, become involved in advertising for the filing of suits. The Court said:

> . . . the receipt of . . . notice sent by Court direction might well have the effect of advertising for the filing of suits of intervention in this pending suit by stockholders who, up to this late date, have shown no interest or desire to do and when, in fact, they may have no just claim to assert.
>
> It is not the purpose of Rule 23 to promote, induce or encourage mass participation litigation by judicial invitation particularly where the facts presented do not clearly indicate that justice requires it. We find no need to apply its provisions to this suit, save to declare that this suit is not to be maintained as a class action (App. B-7).

On appeal, the Court of Appeals for the Second Circuit reversed and held that the action may be maintained as a class action. The Court of Appeals noted that "Rule 23 now emphasizes the flexibility which a trial court exercises in the management of the action", that such flexibility "enables [the Court] to view liberally claims which assert a right to a class action in 10b-5 cases at the early stages of the litigation," and that if "the trial court finds at some convenient time that a distinction must be drawn between those who purchased at different times, it is free to make use of the flexibility available to it and so important to the application of Rule 23. For example, it may divide the class into subclasses . . . or make such other orders as are necessary . . ." (App. A-11, 13).

We believe that the decision of the Court of Appeals offers so much "flexibility" and imposes so much obligation upon the trial court as to cause Rule 23, and the standards it provides, to be virtually without practical meaning. In the case at bar, the situation is aggravated by the posture of the plaintiff who, in styling himself as a champion of 2,200 stockholders, is likely to be at odds with many of them. As the Court of Appeals below noted, the questions at bar are "significant" and "troublesome" (App. A-6). Enough experience has by now been gathered in cases arising under Rule 23 to warrant this Court's review and correction of the erroneous interpretations of Rule 23 made by the Court of Appeals in the case at bar.

Reasons for Granting the Writ

The Court of Appeals noted that "the serious and troublesome question as to when to apply a class action under 10b-5 [of the Securities Exchange Act of 1934] is one of great importance" (App. A-6). We believe, as we discuss in this petition, that the Court of Appeals erred

in important respects and that its errors are likely to cause substantial difficulties in the administration of these troublesome cases. For the reasons discussed in this petition, the Court of Appeals decision improperly determined "important question[s] of Federal law which ha[ve] not been but should be settled by this court" and "has so far departed from the accepted and usual course of judicial proceedings . . . as to call for an exercise of this court's power of supervision" (U. S. Sup. Ct. Rule 19). We therefore ask that this Court issue a writ of certiorari to review the order of the Court of Appeals.

POINT 1.

THE COURT OF APPEALS ERRED IN NOT CONSIDERING THE CONSEQUENCES OF THE CONFLICTING INTERESTS BETWEEN PLAINTIFF AND SUBSTANTIAL NUMBERS OF THE PERSONS PLAINTIFF PURPORTS TO REPRESENT, AND IN DETERMINING THAT THE COURT'S POWER UNDER RULE 23 TO CREATE SUB-CLASSES MADE IT REVERSIBLE ERROR FOR THE DISTRICT COURT TO HAVE DISMISSED THE ACTION AS RESPECTS THOSE PERSONS WHO, BECAUSE OF CONFLICTS, PLAINTIFF CANNOT PROPERLY REPRESENT.

Plaintiff, the purchaser of 100 shares of Wolf's Common Stock in the open market on June 13, 1962, seeks to represent, not only those persons who, like him, purchased their shares at prices allegedly inflated by misstatements and omissions purportedly made in the third prospectus of Wolf, but also those who purchased their shares pursuant to the first and second prospectuses of Wolf, those who purchased their shares well after the time plaintiff made his purchases, those who purchased debentures rather than stock, and those who sold, rather than held, their securities. The Court of Appeals, by permitting the plaintiff to proceed for the entire class he purports to represent, has fashioned a

rule which permits a plaintiff to represent those with whom he has conflicting interests on the theory that the trial court, by its power to create sub-classes, will be able to resolve the conflicts as they manifest themselves during the course of the litigation. We show below that the rule fashioned by the Court of Appeals is faulty, meriting review and correction by this Court.

A. The Conflict of Interests Between Plaintiff and The Persons He Purports to Represent

The Court of Appeals below accepted plaintiff's contention that six of the 16 alleged misstatements and omissions presented common questions of law and fact, and held that these questions, since they were substantial in dollar amount, "predominated" over the non-common questions presented by the 10 other alleged misstatements and omissions (App. A-15) (Fed. R. Civ. P. 23(b)(3)). There are at least three difficulties with that view:

(a) The Court failed to express any criteria as to how to determine whether common questions "predominated" over non-common questions, leaving the implication that this criterion of Rule 23 was largely to be ignored so long as the allegedly common questions appear to be substantial.

(b) The Court failed to require a hearing, and, indeed, held against a hearing, to aid it in deciding between plaintiff's and defendant's contentions as to whether the six misstatements claimed by plaintiff to be common were, indeed, common (App. A-19), leaving the implication that, at least with respect to an action under section 10b of the Securities Exchange Act, the standards of Rule 23 could be satisfied by pleadings even though the allegations of those pleadings in respect of those standards were sharply disputed.

(c) The Court overlooked the consequences of serious conflicts likely to arise among the diverse groupings of the persons plaintiff purports to represent. Had a hearing been held, the Court might have appreciated those consequences.

The plaintiff, since he purchased in connection with the third prospectus, may be able to establish a case with respect to the six misstatements contained in that prospectus alone. With proof of four additional misstatements contained only in the second and third prospectuses, he may be able to establish a case applicable as well to persons who purchased at or around the time the second prospectus was filed. The group of persons involved with respect to the third prospectus and the group involved with respect to the second prospectus is large, both separately and together. Each group is large enough so that the plaintiff and his counsel can reap a handsome reward by confining their activities to this group or groups, without producing any benefit to the group of persons who made their purchases in connection with the first prospectus.

This is not academic reasoning. By reason of the "stop-order" proceeding brought by the SEC, a great deal of materials are in plaintiff's possession applicable to the second and third prospectuses, but not applicable, in any substantial way, to the first prospectus. The economics of prosecution may dictate a heavy concentration on the second and third prospectuses and a cursory preparation in respect of the first.

The conclusion that must plainly be drawn is that plaintiff's interests will, in all likelihood, substantially conflict with those who purchased prior to the filing date of the second prospectus, that is, between June 2, 1961 and January 25, 1962, and that plaintiff's interests to a lesser degree are likely also to conflict with those who purchased in connection

with the second prospectus and prior to the third prospectus, that is, between January 26, 1962 and May 31, 1962.

As the Court in *Richland* v. *Cheatham,* 272 F Supp. 148 (S. D. N. Y. 1967), observed, the basic characteristic of a true class is that the representative's success means success for all. By this test, those who purchased Wolf securities prior to June 1, 1962 are not in a class that plaintiff is capable of representing.

Plaintiff's interests conflict also with those who purchased after him, another group in the class he purports to represent. Financial statements do not have any lengthy currency. Progressively after June 13, 1962, plaintiff's date of purchase, the alleged misstatements contained in the third prospectus tended to become stale. Yet plaintiff purports to sue for a class that does not close until December 31, 1963, a year and a half after his purchase. One may well ask how that group will fare under plaintiff's proofs of misrepresentations that he claims were made in one or all of the three prospectuses. It is common sense that proof of an artificially inflated price caused by one or all of these prospectuses is far from satisfactory proof that the artificial inflation continued through 1963. As was stated in *Richland* v. *Cheatham, supra,* proof of a manipulated price at one period of time would "not prove that purchasers at other periods of time paid a manipulated price."*

We turn now to an examination of the six alleged misstatements plaintiff claims were common. We submit that the Court of Appeals erred in accepting, without a hearing, plaintiff's contention that these six alleged misstatements were common to all three prospectuses. The Court's willingness to accept at face value allegations that become the

*One of petitioners' contentions is that neither the second nor third prospectus, each being preliminary in nature and bearing the advisory legend, as required by SEC regulations, that it was subject to completion or amendment, had any appreciable impact on the market price of Wolf's securities.

basis for its ruling that a class suit is properly brought, without subjecting such sharply disputed allegations to a hearing, seems to us to present a basic issue in the application of Rule 23 meriting review by this Court.

Plaintiff's position is that Wolf's statement of cash-available-for-distribution-to-stockholders is overstated in all three prospectuses, and that common misrepresentations and omissions are the reason for the overstatement (39a). The common element is alleged to stem mainly from a situation with respect to the Tidelands Motor Inn ("Tidelands"), and so the Court of Appeals ruled (29a-32a; App. A-15). We submit that had the Court had the benefit of a hearing, it would not have accepted plaintiff's contention.

The rental payable by Tidelands, $187,000 yearly, was included in each of the prospectuses as an asset in computing the cash available for distribution to Wolf's stockholders (39a). On June 1, 1961, at about the date of the first prospectus, the Tidelands rent allegedly was in arrears to the extent of $1,083, less than one month's rent, and the last installment of its tax bill, $14,144, had not been paid. (Ex. 5, pp. 8-9). As a new motel in a region expecting large growth, the situation was far from being a matter of concern. On March 31, 1962, some two months before the third prospectus was filed, Tidelands allegedly owed $99,968 in past due rent and its unpaid tax bill amounted to $12,012 (Ex. 5, pp. 8-10).

Plaintiff claims that the rent receivable shown in Wolf's books for Tidelands should have been considered worthless, for all three prospectuses. Whether he is wrong or right will present different questions depending on the conditions existing at the time of each of the three prospectuses, with plaintiff's case being the strongest and easiest to prove in respect of the third prospectus and the weakest and most difficult to prove with respect to the first prospectus. Since plaintiff, for the reasons previously discussed, would other-

wise be prone to favor the class benefiting by the proofs relating to the third prospectus, the interests of that class (of which plaintiff is a member) are likely to conflict with those who purchased at other periods of time.

Other conflicts of interests exist between plaintiff and the diverse groupings of persons he purports to represent.

Plaintiff, as a present shareholder of Wolf, has an interest in this action which is at odds with those persons who have sold their securities and whom plaintiff claims also to represent. A recovery against Wolf will tend adversely to affect the investment which present shareholders have in the company.* Those who have previously sold their securities and have established their losses no longer have any interest in the continued success of Wolf and would probably reflect that attitude in considering the adequacy of any settlement offer or the collectibility of any judgment.

Similarly, plaintiff's interests as a shareholder are in conflict with those who hold debentures. A bondholder might be less willing to settle and more determined to proceed to judgment, for even if Wolf faced financial difficulty as a result of any settlement or judgment, the bondholder would have a priority in payment, whereas a shareholder might end up with no recovery if he pursued his claim beyond Wolf's ability to pay. For just such reasons, the Court in *Herbst* v. *Able,* 45 F. R. D. 451, 454 (S. D. N. Y. 1968), ruled that since those who are shareholders of a company "are owners of part of the equity of the corporation, and presumably have an interest in protecting that investment," their interests are different and perhaps in conflict with the

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*This is especially so since the market price of Wolf's shares have risen since the institution of this action to exceed the alleged inflated price which the plaintiff paid in June, 1962. If plaintiff still holds the shares upon which this action is based, it may be that he has suffered no recoverable loss and, therefore, cannot represent others who may have suffered a loss.

interests of those who had sold their stock. The court in that case ordered a hearing on the issues presented.

The Court of Appeals, we submit, announced a rule that the interests of promoting section 10b litigation outweigh all criteria provided by Rule 23 for determining whether and to what extent an action has been properly brought for a class. We ask that this Court review this problem, a problem which the Court of Appeals noted was both "serious and troublesome" (App. A-6).

B. A representative may not act as such for persons with whom he is, or is likely to be, in conflict.

In order for a party adequately to represent a class, his interests must be wholly compatible with, and not in any way antagonistic to, those whom he would represent. 3A MOORE, FEDERAL PRACTICE ¶23.07(3) at p. 3428 (2d Ed. 1968).

In *Hansberry* v. *Lee,* 311 U. S. 32 (1940), the issue presented was whether a determination of a class action was binding upon members purportedly within the class but whose interests conflicted with those of the class representative. This Court held that the persons affected were not to be deemed part of the class, and stated that "selection of representatives for the purpose of litigation, whose substantial interests are not necessarily or even probably the same as those whom they are deemed to represent, does not afford that protection to absent parties which due process requires" (Id. at p. 45). See also *Eisen* v. *Carlisle & Jacquelin,* 391 F. 2d 555, 562-63 (2d Cir. 1968); *Carroll* v. *American Federation of Musicians,* 372 F. 2d 155, 162 (2d Cir. 1967) ("Since all members of the class are to be bound by the judgment, diverse and potentially conflicting interests within the class are incompatible with the maintenance of a true class action"); *Anderson* v. *Moorer,* 372 F. 2d 747 (5th Cir. 1967).

Under Rule 23, any determinations made by a Court in a class action are binding upon all members of the class (Rule 23(c)(2)(B)). The theory, of course, is that a representative had the opportunity, and the incentive, to present the positions of the members of the class, and that the determination by the Court followed upon the full force of advocacy.

As the Court of Appeals in the decision at bar stated:

> . . . one of the important changes introduced by the present Rule 23 was to make the judgment in a class action binding upon all members of the class, whether they appear in the action or not, unless a member affirmatively "opts out" of the litigation at the onset. Rule 23(c) (2) (B). Because of the conclusiveness of a class judgment, it follows that a court must carefully examine the class on whose behalf plaintiff sues, to decide if it is a true class and if the plaintiff is the proper representative. (App. A-11).

(See also *Eisen* v. *Carlisle & Jacquelin,* 391 F. 2d 555, 562 (2d Cir. 1968)).

Because of the conflicts shown above, the plaintiff at bar is likely not to have the incentive to champion the interests of all the securities holders he purports to represent. If he can use the material gathered by the SEC in the course of its "stop-order" proceeding and with facility prove a sizeable case in relation to all those who, like himself, purchased securities after the third prospectus, or even after the second and third prospectuses, he may not be motivated to conduct arduous discovery and trial proceedings with respect to the significantly different issues involved in respect of the first prospectus. If plaintiff proves that the artificially inflated price of Wolf securities did not abate until after the news of the "stop-order" proceedings became

public knowledge, sometime in 1964, and, because he continues to hold his shares, is not interested in proving that the "water" abated prior to 1963, plaintiff may be harming those who, because they sold their securities prior to the end of 1963, are interested in proving that they suffered a detriment because of inflated values when they made their purchases but received no benefit from such inflated values when they sold.

Because of Rule 23, all members of the class, whether adequately represented or not, will be bound by the determinations of the court, whether those determinations follow the full force of advocacy or not. If there are no suitors to represent groupings with interests at odds with those of the plaintiff, actually or potentially, the persons in such groups are likely to suffer substantial prejudice. The ruling of the Court of Appeals below creates a precedent which does not take sufficient account of this failing, and should be reviewed by this Court.

C. The power of the District Courts under Rule 23 to create subclasses should not excuse the failure of the Court to consider the consequences of the conflicting interests, as between the plaintiff and the persons he purports to represent, and to dismiss the suit as to those for whom he cannot properly act as a representative.

The Court of Appeals assumed that sub-classes could be created to assure that each of the conflicting groupings in the class plaintiff purports to represent would be properly represented. That assumption depends on the existence of a number of plaintiffs, enough to represent the diverse groupings in the class for whom plaintiff has sued. In the meantime, the Court below held, the district court could on its own initiative supervise the proceedings to assure that none would be prejudiced.

Our discussion in points 2 and 3 below take up both these assumptions and shows them both to be faulty.

POINT 2.

THE INTERPRETATION OF RULE 23 BY THE COURT OF APPEALS BELOW IMPOSES ON THE DISTRICT COURT AN OBLIGATION ON ITS OWN INITIATIVE TO PROTECT THE RIGHTS OF PERSONS IN THE CLASS WHOM PLAINTIFF PURPORTS TO REPRESENT WHOSE INTERESTS ARE INCONSISTENT WITH THOSE OF THE PLAINTIFF. THE DISTRICT COURT CANNOT EFFECTIVELY CARRY OUT THAT OBLIGATION.

The Court of Appeals, after first noting that it did not "perceive, at this juncture of the case, any conflict of interest between Green and other members of the class," went on to rule that the trial court could "at some convenient time" draw distinctions "between those who purchased at different times . . . and . . . divide the class into subclasses" (App. A-12-13). The Court of Appeals "recommend[ed] to the district court that it make use of the freedom afforded it by Rule 23 to manage the litigation efficiently and fairly, including the creation of any necessary subclasses" (App. A-18).

We discuss in the next point the problems attendant to the formation of subclasses where there are no representatives of those subclasses at bar. In this section, we shall discuss the problems attendant to the "freedom", and, therefore, the obligation, of the district courts "efficiently and fairly" to manage a litigation where there is but a single plaintiff and several diverse groupings of persons whom plaintiff purports to represent.

The pressures on the federal judiciary need not be elaborated upon to this Court, especially the pressures on judges in the Southern District of New York. Suffice it to say that the appointment of a "Rule 2" judge to preside over

all matters in a litigation is a rarity, and is reserved for the most difficult and protracted cases.* Only a "Rule 2" judge could hope to have, and maintain, the familiarity with a class suit as to have a chance "efficiently and fairly" to manage it. This is so where all parties are represented by forceful advocates, and all the more so when a representative has interests which, actually or potentially, conflict with members in the class he purports to represent.

What does it mean to "efficiently and fairly" manage a litigation? How, for example, will a district judge know whether plaintiff's counsel is directing the thrust of his discovery proceedings to favor certain issues affecting some but not all of the groups he purports to represent over other and, perhaps, more difficult issues. To expect the district judge to be able to perform this function of overseer on behalf of absent members of a class is more than was contemplated by Rule 23. Moreover, even if the district judge were able to discern when plaintiff's interest became antagonistic to a segment of the class, can he merely create subclasses to avoid such conflicts? And who will represent those subclasses? Should the court solicit members of those subclasses for a proper representative to intervene in the litigation?

The opinion of the Court of Appeals below gives to the district courts virtually absolute "freedom," and, therefore, an impossible obligation, to manage a class suit where there are too few representatives of the diverse interests in the

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*General Rule 2(b) of the General Rules for the Southern and Eastern Districts of New York provides as follows:

> "The (Southern) chief judge [(Eastern) with the approval of his associate judges], upon his own motion or the motion of any party, may assign a long and complicated case to a judge for all purposes including the following: (1) to hear all motions and preliminary applications; (2) to conduct the pre-trial conference; and (3) to preside at the trial of the action."

* * *

class for whom suit was brought. It was just this type of problem that Justice Black envisaged in his dissent from the transmittal by the Supreme Court to Congress of new Rule 23. Mr. Justice Black stated, 39 F. R. D. 69, 274 (1966):

> . . . I particularly think that every member of the Court should examine with great care the amendments relating to class suits. It seems to me that they place too much power in the hands of the trial judges and that the rules might almost as well simply provide that "class suits can be maintained either for or against particular groups where in the discretion of a judge he thinks it is wise." The power given to the judge to dismiss such suits or to divide them up into groups at will subjects members of classes to dangers that could not follow from carefully prescribed legal standards enacted to control class suits.

The Court of Appeals in the case at law ruled that if there was to be error in resolving questions of the nature posed above, "let it be in favor and not against the maintenance of the class action, for it is always subject to modification should later developments during the course of the trial so require" (App. A-19 fn); See also *Esplin* v. *Hirschi* 402 F. 2d 94 (10th Cir. 1968), *cert. denied,* U. S. , 37 U. S. L. Week 3355 (March 24, 1969). It is doubtful, however, that a trial court could by later order reverse the prejudice that has resulted from the activities of an inadequate representative. The proofs in a complicated litigation are too cumbersome and involved for a court continually to understand, and the strategies of counsel too difficult for a court effectively to judge, whether a representative is fairly and efficiently conducting proceedings for the best interests of all the diverse groupings of the persons he purports to represent. If the determinations required under Rule 23 are not made at the outset, after hearing as we

suggest in point 4 below, the proper determinations more probably than not never will be made.

In sum, the Court below erred in assuming that the power of the district court to create subclasses, and its freedom to manage a class suit "efficiently and fairly", could solve problems of conflicts. The decision of the Court of Appeals promises to impose a difficult and unmanageable burden on the federal courts and should, therefore, be reviewed and corrected by this Court.

POINT 3.

THE COURT OF APPEALS BELOW ERRED IN ESTABLISHING A PROCEDURE BY WHICH THE DISTRICT COURTS WILL CAUSE ALLEGEDLY AGGRIEVED PERSONS, WHOM A PLAINTIFF CLAIMS TO REPRESENT BUT WHOM HE CANNOT REPRESENT BECAUSE OF CONFLICTING INTERESTS, TO BE SOLICITED FOR THE PURPOSE OF INVITING THEM TO INTERVENE AND BRING SUIT.

The Court of Appeals assumption that subclasses could be created to assure proper representation for each of the conflicting groupings of persons plaintiff purports to represent, depends on the existence of a sufficient number of plaintiffs to represent such diverse groupings. Since there is presently but one plaintiff, the District Court has a dilemma:

1. Manage the lawsuit itself to assure that the lawsuit will be conducted "efficiently and fairly" as respects the class of which plaintiff is fairly a representative and as respects other diverse groupings among the persons for whom plaintiff has purported to bring suit. As we have shown in the previous point, this is an obligation which the district courts cannot effectively fulfill.

2. Solicit all the persons in whose right plaintiff has purported to sue, in the hope that enough intervenors

will come forward to assure adequate representation for all the diverse groupings involved. As we show below, activity of this sort would seem to involve the courts in an impropriety.

Canon 28 of the Canons of Professional Ethics declares it unprofessional for lawyers to stir up litigation, directly or through agents. Canon 28 provides as follows:

> 28. Stirring up litigation, directly or through agents.
>
> It is unprofessional for a lawyer to volunteer advice to bring a lawsuit, except in rare cases where ties of blood, relationship or trust make it his duty to do so. Stirring up strife and litigation is not only unprofessional but it is indictable at common law. It is disreputable to hunt up . . . causes of action and inform thereof in order to be employed to bring suit or collect judgment, or to breed litigation by seeking out those . . . having any other grounds of actions in order to secure them as clients . . . (YEAR BOOK, ASS'N OF BAR, CITY OF NEW YORK 276-77 (1968).

The court ought not to do what it would be unprofessional for a lawyer to do. It is one thing to invite members of a class already represented to enter an appearance, if any of them desire, through counsel. Rule 23(c)(2)(C). It is another to invite members of a group who are not properly represented before the court to come forward with a representative, for in the latter instance the court is doing what the Canons of Professional Ethics forbid, that is, seeking out those with claims and persuading them to bring a lawsuit that otherwise would not properly be before the court.

In addition to the impropriety, there is a serious possibility that the Court may be causing prejudice by such a

gratuitous notice. The effect of a notice is to bind the class except those who opt to be excluded. Rule 23(c)(2)(A), (B). If, as a result of such a notice, a member of the class misconceives the adequacy of representation and remains silent, and no person representative of his class' interest comes forward, the members of that class may be prejudiced and yet be bound by the result of the lawsuit carried forward by the inadequate representative.

As with so many aspects of court conduct, there is great wisdom in the notion that judicial determinations should follow upon, and not precede, the full force of advocacy of the various points of view involved in a dispute. The Court of Appeals below departed from that principle. This Court, we believe, should review and correct that departure.

POINT 4.

THE COURT OF APPEALS BELOW ERRED IN REVERSING THE DECISION OF THE DISTRICT COURT UPON THE PLAINTIFF'S VERSION ALONE AND WITHOUT ORDERING A HEARING AS TO DISPUTED ISSUES.

We have several times adverted to the failure of the Court of Appeals to order that material and disputed issues be submitted to a hearing before deciding that plaintiff adequately represents all 2,200 members of the groups for whom he purports to have brought suit. Manifestly, the consequences of the conflicts among these groupings and the extent to which plaintiff or the defendants are correct in their respective contentions as to whether issues are common or not can be better understood after a hearing than without one.

A number of district courts have ruled in favor of such a hearing, *Herbst* v. *Able,* 45 F. R. D. 54 (S. D. N. Y. 1968); *Dolgow* v. *Anderson,* 43 F. R. D. 472 (E. D. N. Y. 1968), and so in an earlier case did the Court of Appeals

for the Second Circuit, *Eisen* v. *Carlisle & Jacquelin,* 391 F. 2d 555 (1968).

In the *Eisen* case, the Court of Appeals reversed the dismissal of a class action which had been brought on behalf of all purchasers and sellers of "odd-lots" on the New York Stock Exchange, and remanded the case for an "evidentiary hearing . . . on the questions of notice, adequate representation, effective administration of the action and any other matters which the District Court may consider pertinent and proper" (391 F. 2d at p. 570).

In *Herbst* v. *Able, supra,* a number of alleged class actions were brought on behalf of those who held or had sold debentures or shares of Douglas Corp. The defendants allegedly made false and misleading statements, in violation of the Securities Act of 1933 and Section 10b of the Securities Exchange Act of 1934, which the plaintiffs claimed induced them and members of the alleged class in whose rights they sued to purchase or convert securities of Douglas. The district court ruled that it was unable to make a determination as to whether a class action existed on the basis of the submitted papers alone, and directed an evidentiary hearing to be held to aid it in coming to a decision (45 F. R. D. at pp. 454-5).

In *Dolgow* v. *Anderson,* 43 F. R. D. 472 (E. D. N. Y. 1968), *supra,* Judge Weinstein held a hearing to determine whether a plaintiff's class suit was substantial enough to permit a possibly damaging notice to be sent to the class he purported to represent and to permit him to proceed with expensive and time consuming discovery procedures. After a hearing, Judge Weinstein dismissed the class suit. *Dolgow* v. *Anderson,* Civil No. 66-1057 (E. D. N. Y. April 19, 1969). In *School Dist. of Phila.* v. *Harper & Row Publishers, Inc.,* 267 F. Supp. 1001, 1006 (E. D. Pa. 1967), Court, in dismissing an alleged class action as one including "a myriad of complex, frustrating, needless problems

in attempted management," commented that, prior to the dismissal, there had been "numerous hearings and conferences."

Not all district judges have ruled in favor of such a hearing. See, e.g., *Mersay* v. *First Republic Corp.*, 43 F. R. D. 465, 469 (S. D. N. Y. 1968). The Court of Appeals, in the case at bar, held that a hearing was not appropriate, and ruled on the papers alone that the plaintiff could proceed with his action "on a class suit basis." "Any hearing on the sufficiency of his claim," the Court of Appeals ruled, would be redundant (App. A p. 19, fn.).

It is this ruling of the Court of Appeals that we believe to be error. Both the District Court and the Court of Appeals determined that it could decide whether a class action was proper or not on the basis of papers alone, and both thereupon reached opposite results. It would seem that the questions presented are sufficiently serious and of a sufficiently complex nature as to require a hearing, for only by a hearing can there be a proper assessment of the results—beneficial and harmful—affecting the diverse groupings of the persons plaintiff purports to represent, and a substantially just determination of the issues presented.

CONCLUSION

As the Court of Appeals observed, Rule 23 was promulgated in the interest of judicial efficiency, to eliminate the prospect of multiple suits arising from the same questions of fact and law, and to enable a few representatives of a class to sue on behalf of others similarly situated and be granted a judgment that would bind all (App. A-10). The Court of Appeals observed, also, that it was "mindful that the serious and troublesome question as to when to allow a class action under 10b-5 is one of great importance," and that it was influenced in coming to its decision by its desire to assure "recourse for thousands of stockholders to whom the courthouse would thus be out of bounds" and in order

to avoid a "multiplicity and scattering of suits with the inefficient administration of litigation which follows in its wake" (App. A-6, 18-19).

We do not, of course, seek by this petition to take issue with these laudable purposes. We do, however, urge that great mischief is likely to arise from rulings that cause the courts to overlook the safeguards provided by Rule 23 to assure that suitors be representative of those whose rights they champion and that no one be bound unless he is fairly represented. There has now been sufficient experience in the application of Rule 23 to warrant this Court's review and correction of the rulings of the Court of Appeals discussed in this petition.

Respectfully Submitted,

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Dated: May 8, 1969.

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 82—September Term, 1968.

(Argued October 28, 1968 . Decided December 9, 1968.)

Docket No. 32335

LEON GREEN, on behalf of himself and all others similarly situated,

Appellant,

—v.—

WOLF CORPORATION, JOSEPH WOLF, JOSEPH ECKHAUS, LEON SPILKY, DAVID BERDON & Co., and TROSTER SINGER AND Co.,

Appellees.

Before:

LUMBARD, *Chief Judge,*
KAUFMAN and HAYS, *Circuit Judges.*

Appeal from an order of the Untied States District Court for the Southern District, Sylvester J. Ryan, *J.*, striking those portions of the complaint, in an action under § 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, which alleged the appellant was maintaining the suit as a class action and which sought punitive damages. Order reversed with respect to the class action allegations. Also,

the District Court properly struck the prayer for punitive damages.

IRVING MALCHMAN, New York, N. Y. (Malchman & Klied, on the brief), *for appellant.*

GEORGE F. ADAMS, New York, N. Y. (F. W. H. Adams, Satterlee, Warfield & Stephens, on the brief), *for appellee Troster, Singer & Co.*

MILTON E. MERMELSTEIN, New York, N. Y. (Jay D. Fischer, Mermelstein, Burns & Lesser, on the brief), *for appellees, Wolf Corporation, Joseph Wolf, Joseph Eckhaus, Leon Spilky.*

GERALD D. FISCHER, New York, N. Y. (Stroock, Stroock & Lavan, on the brief), *for appellee David Berdon & Co.*

KAUFMAN, *Circuit Judge*:

We are called upon to decide two significant questions relating to § 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b), and Rule 10b-5: Under what circumstances does Fed. R. Civ. P. 23 permit a class action alleging a violation of 10b-5. And, may punitive damages be assessed against those who do not meet the standards of conduct required by that rule.

Leon Green appeals from an order of the District Court for the Southern District of New York striking those parts of his complaint which purported to make the suit a class action and those other allegations which sought punitive

damages. We believe that this litigation has been properly brought as a class action but that the District Court should not reinstate Green's claim for punitive damages.

I—Facts[1]

The Wolf Corporation was organized in January, 1961 by three real estate investors, Joseph Wolf, Joseph Eckhaus, and Leon Spilky[2] who exchanged certain real estate holdings for $775,000 of the corporation's subordinated debentures. Wolf Corp. [hereinafter Wolf] then filed a registration statement and prospectus [the first prospectus] with the Securities and Exchange Commission in February 1961, to become effective on June 2, 1961, in connection with the issuance of 806,350 shares of Class A common stock and $3,583,000 in fifteen years, 7.2% subordinated debentures. 746,350 shares of the stock and $2,808,000 of the debentures were to be exchanged for the interests of various limited partners in certain real estate syndicates of which Messrs. Wolf, Eckhaus and Spilky were the general partners. The other 60,000 shares of Class A common stock were offered to the public at $10 a share, conditioned on consummation of the "exchange" offer with the limited partners. This registration was approved by the SEC and the stock in question was sold to the public.

On January 26, 1962, Wolf filed a second registration with the SEC, accompanied by a prospectus [the second prospectus]. These documents related to a proposed issue of $4,500,000 of 6.5% convertible subordinated debentures with detachable warrants to purchase 450,000 shares of Class A common stock. This second registration was

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[1]We have assumed for the purpose of this appeal, as we are required to do, that the "facts" stated in the complaint and accompanying papers submitted to Judge Ryan are true. No such finding, of course, is to be inferred.

[2]All are defendants in this action.

amended in June 1962 to cover the issuance of a different combination of securities: $1,321,500 in 6½% convertible subordinated debentures and 264,300 shares of Class A common. Another prospectus [the third prospectus] was prepared in connection with this amended second registration. The third prospectus was subscribed "Underwriter Troster, Singer & Co." [hereinafter Troster, Singer]. The second prospectus noted that this was Troster, Singer's first venture as an underwriter. Troster, Singer is a defendant in this action, and Green concedes that its liability, if any, is only to those who purchased Wolf stock after June 1, 1962, the date of the third prospectus.

The SEC began an investigation of Wolf on July 13, 1962. This was grounded on allegedly untruthful statements in the second registration statement, including alleged inaccuracies in the cash Wolf claimed was available for distribution to stockholders. By a decision and order dated May 4, 1966, the SEC found "serious and extensive" deficiencies in the second registration statement, as amended in June 1962, but nonetheless consented to Wolf's offer to withdraw the registration and the second and third prospectuses accompanying it. As a condition to the SEC's consent it required Wolf to notify its stockholders and all those who had received the prospectuses of what the Commission characterized as "the dismal record of the abortive financial program and the deceptive financial presentation of the registrant's earlier record of operations." Wolf Corp. No. 4830 at 11 (SEC, May 4, 1966). Thus the second registration never became effective and no stock was sold pursuant to it.

Green began his association with Wolf by purchasing a limited partnership in one of the real estate syndicates covered by the "exchange offer" for the sum of $3,500. On June 2, 1961 he surrendered this interest for 350 shares of Wolf Corp. stock and $777 in subordinated debentures. On

June 13, 1962, shortly after the third prospectus was issued, Green purchased 100 shares of Wolf stock in the open market at $10¼ a share for a total price of $1,042.27 (including commissions). The purchase of these shares, he acknowledges in his brief,[3] is the sole basis for his suit. All 100 shares were still in his possession when this action was commenced.

We are presented with the difficult task of interpreting the class action rule, Fed. R. Civ. P. 23 [hereinafter Rule 23], because Green seeks to bring this action on behalf of all those who purchased the common stock or subordinated debentures of Wolf Corp. between June 2, 1961 and the end of 1963, a group consisting of about 2,200 persons. It is conceded that no other purchaser has brought an action arising from the alleged acts which were committed approximately six years ago. Nor has any shareholder sought to intervene in this suit.

Green asserts that the three prospectuses, which together are alleged to be the sum of information disclosed by Wolf to the general public and to the financial community during the period in question, contain untrue or misleading statements. In particular, he claims that the item "Cash Available for Distribution to Shareholders" in the balance sheet incorporated in each prospectus was overstated. Green claims that this item is of great significance to potential buyers of shares in a real estate corporation, for it is said to be the key to what the likely return may be on this type of investment. Thus, he argues that the more cash the balance sheet reflects as available for distribution, the higher the potential price of the stock is expected to reach, and hence the greater the inflation of the cash available item, the more

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[3] In the court below, Green relied in part on stock he received in the "exchange offer." He sold 200 shares of this stock on June 22, 1962 at a price of $10 per share and 125 shares on December 16, 1965 at a price of $1½.

significant the impact on the price of the stock. These serious misrepresentations and omissions, Green alleges, artificially inflated the price of Wolf stock.[4] The complaint alleges that Green (and presumably members of the class he seeks to represent), relied on the misstatements and omissions in that none were aware the price of the stock had been inflated to an artificially high level by the misleading information. All of this, it is claimed, violates § 10(b) and Rule 10b-5 [hereinafter 10b-5]. For himself, Green seeks to recover the difference between the price he paid, $10¼, and the "true" or unmanipulated value of Wolf stock, which he puts at between $1 and $2½; the total damage to Green is thus less than $1,000.[5]

II—Class Actions

We are mindful that the serious and troublesome question as to when to allow a class action under 10b-5[6] is one of great importance. This is so because "[t]he ultimate effectiveness of the federal remedies when the defendants are not prone to settle may depend in large measure on the applicability of the class action device." 3 Loss, Securities Regulation 1819 (2d ed. 1961). While other federal securities antifraud provisions are important none have become as far-reaching as Rule 10b-5 which, although little used

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[4]Green asserts that although the second and third prospectuses were never available to the general public, they were distributed widely in the financial community, which functions as the "eyes and ears" of the public in creating a demand for particular stocks.

[5]The particular misstatements on which Green bases his suit are discussed *infra* at 508-511.

[6]We note that the order striking the class action aspects of the complaint is appealable at this time, since if a class action is not permitted the litigation will very likely terminate without reaching the merits, *Eisen* v. *Carlisle & Jacquelin*, 370 F. 2d 119 (2d Cir. 1966) (Eisen I), cert. denied 386 U. S. 1035. Green obviosly does not intend to press what will probably be an enormously complex and expensive action to recover less than $1,000.

in its early years, now represents approximately one-third of all current cases, public and private, brought under the whole array of SEC statutes. It generates almost as much litigation as all the other general antifraud provisions combined. Bromberg, Securities Law: Fraud: SEC Rule 10b-5 § 2.5(6) at 45-46 (1968); 77 Yale L. J. 1585 (1968). If, as here, the security in connection with which the alleged misrepresentations and violations of 10b-5 have been made is publicly held, a class action may well be the appropriate means for expeditious litigation of the issues, because a large number of individuals may have been injured, although no one person may have been damaged to a degree which would have induced him to institute litigation solely on his own behalf.[7]

A. *Development of Rule 23*

The ontogeny of Rule 23[8], which became operative July 1, 1966, illustrates the need for an effective use of class

[7]"The type of injury which tends to affect simultaneously the interest of many people is also apt to involve immensely complex facts and intricate law, and redress for it is likely to involve expense totally disproprotionate to any of the individual claims." Kalven & Rosenfield, The Contemporary Function of the Class Suit, 8 U. Chi. L. Rev. 684 (1941). See *Escott* v. *Barchris Const. Corp.*, 340 F. 2d 731, 733 (2d Cir. 1965), cert. denied 382 U. S. 816 (1966).

[8]The text of Rule 23 reads:

CLASS ACTIONS

(a) *Prerequisities to a Class Action.* One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

(b) *Class Actions Maintainable.* An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

actions in securities act litigation. See generally Cohn, The New Federal Rules of Civil Procedure, 54 Geo. L. J. 1204, 1213-26 (1966); Frankel, Some Preliminary Observations Concerning Civil Rule 23, 43 F. R. D. 39 (1968); Kaplan,

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(1) the prosecution of separate actions by or against individual members of the class would create a risk of

(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or

(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

(c) *Determination by Order Whether Class Action to be Maintained; Notice; Judgment; Actions Conducted Partially as Class Actions.*

(1) As soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained. An order under this subdivision may be conditional, and may be altered or amended before the decision on the merits.

(2) In any class action maintained under subdivision (b) (3), the court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice shall advise each member that (A) the court will exclude him from the class if he so requests by a specified date; (B) the judgment, whether favorable or not, will include all

Continuing Work of the Civil Committee: 1966 Amendments to the Federal Rules of Civil Procedure (I), 81 Harv. L. Rev. 356, 375-400 (1968). Equity has long recognized that there is need for a course which would redress

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members who do not request exclusion; and (C) any member who does not request exclusion may, if he desires, enter an appearance through his counsel.

(3) The judgment in an action maintained as a class action under subdivision (b) (1) or (b) (2), whether or not favorable to the class, shall include and describe those whom the court finds to be members of the class. The judgment in an action maintained as a class action under subdivision (b) (3), whether or not favorable to the class, shall include and specify or describe those to whom the notice provided in subdivision (c) (2) was directed, and who have not requested exclusion, and whom the court finds to be members of the class.

(4) When appropriate (A) an action may be brought or maintained as a class action with respect to particular issues, or (B) a class may be divided into subclasses and each subclass treated as a class, and the provisions of this rule shall then be construed and applied accordingly.

(d) *Orders in Conduct of Actions.* In the conduct of actions to which this rule applies, the court may make appropriate orders; (1) determining the course of proceedings or prescribing measures to prevent undue repetition or complication in the presentation of evidence or argument; (2) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct to some or all of the members of any step in the action, or of the proposed extent of the judgment, or of the opportunity of members to signify whether they consider the representation fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action; (3) imposing conditions on the representative parties or on intervenors; (4) requiring that the pleadings be amended to eliminate therefrom allegations as to representation of absent persons, and that the action proceed accordingly; (5) dealing with similar procedural matters. The orders may be combined with an order under Rule 16, and may be altered or amended as may be desirable from time to time.

(e) *Dismissal or Compromise.* A class action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs. As amended Feb. 28, 1966, eff. July 1, 1966.

wrongs otherwise unremediable because the individual claims involved were too small, or the claimants too widely dispersed. Moreover, early in the development of our civil procedures it became apparent that judicial efficiency demanded the elimination of multiple suits arising from the same facts and questions of law. Hence, the wise and necessary procedure was created by which a few representatives of a class could sue on behalf of others similarly situated and be granted a judgment that would bind all.[9] See e.g. *Smith* v. *Swormstedt,* 57 U. S. (16 How.) 288 (1853) (6 plaintiffs representing 1500 preachers of the southern sector of the Methodist Episcopal Church against three defendants representing 3800 ministers of the northern sector, after the church split over the slavery issue).

Unfortunately, the class action device became overencumbered and entangled. The old Federal Rule of Civil Procedure 23, effective from 1938 to 1966, sought to separate class actions into a trichotomy known as "true," "hybrid," and "spurious," depending upon the character of the litigation. The courts gave each division a varying degree of effect in binding the class by the judgment, with the spurious class action binding only those members of the class actually before the court. The system proved to be ill-devised. See Kaplan, *supra* (81 Harv. L. Rev.), at 380-86; Keefe, Levy, Donovan, Lee Defeats Ben-Hur, 33 Corn. L. Q. 327, 334 (1968) (describing the attitude of the old rule as "unthinking formalism"). Spurious class actions thus failed to fulfill one of the principal reasons for the existence of class suits—to improve judicial efficiency by reducing the number of suits that might arise from a single

[9]The traditional concept was simply stated in the ancient Federal Equity Rule 38. "When the question is one of common or general interest to many persons constituting a class so numerous as to make it impracticable to bring them all before the court, one or more may sue or defend for the whole." 226 U. S. 659 (1912).

wrong to many individuals. Thus, one of the important changes introduced by the present Rule 23 was to make the judgment in a class action binding upon all members of the class, whether they appear in the action or not, unless a member affirmatively "opts out" of the litigation on the onset. Rule 23(c)(2)(B). Because of the conclusiveness of a class judgment, it follows that a court must carefully examine the class on whose behalf plaintiff sues, to decide if it is a true class and if the plaintiff is the proper representative.

To compensate for the increased sweep and gravity of a class judgment, however, Rule 23 now emphasizes the flexibility which a trial court exercises in the management of the action. This should serve to focus the attention of the courts on the need to conduct the litigation without undue complication or repetition. See Rule 23(d); Cohn, *supra* at 1218. It is this flexibility which indeed enables us to view liberally claims which assert a right to a class action in 10b-5 cases at the early stages of the litigation, as we have on this appeal from an order to strike part of the complaint.[10] See generally Note, Class Action Treatment of Securities Fraud Suits Under the Revised Rule 23, 36 Geo. Wash. L. Rev. 1150 (1968). The Court of Appeals for the Tenth Circuit has stated the guiding principle thus:

> "It cannot be denied that the resolution of the class action issue in suits of this type places an onerous burden on the trial court. But if there is to be

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[10]Compare *Brennan* v. *Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N. D. Ind. 1966) where the court allowed a 10-b-5 suit to proceed as a class action, with the possibility that its order might be amended later to strike the class action or to create subclasses, with *Richland* v. *Cheatham*, 272 F. Supp. 248 (SDNY 1967) where a class action was denied, with the possibility of reinstating it after it had progressed further. We believe *Brennan* follows the better route, since once the class action aspect is struck, the litigation is likely to terminate.

an error made, let it be in favor and not against the maintenance of the class action, for it is always subject to modification should later developments during the course of the trial so require." *Esplin* v. *Hirshi,* F. 2d , CCH Fed. Sec. L. Rev. ¶92,276 at 97,234 (10th Cir. Sept. 30, 1968).

B. *Requirements of the Rule*

Rule 23 requires a litigant who would bring a class action to overcome two hurdles. First, he must satisfy all the conditions of 23(a) and then he must also convince the court that his action is appropriate under one of the three subdivisions of 23(b). Here, Green relies on 23(b)(3) which requires the court to find that common questions of fact or law predominate as to all members of the class and that a class action is superior to alternative ways of conducting the litigation.

Since the class Green seeks to represent numbers over 2,000, the requirement of 23(a)(1) that joinder of all members would be impracticable is easily met.[11] We are also of the view that the representative party will fairly and adequately protect the interest of the class, Rule 23(a)(4). We do not perceive, at this juncture of the case, any conflict of interest between Green and other members of the class. Moreover, it should be noted that Green was the only individual to bring suit before the Statute of Limitations barred other actions based on the alleged misrepresentations. We have also explained that quantitative factors, such as the fact that no other shareholders have sought to intervene in this action, are not relevant to consideration of the adequacy of plaintiff's representation under Rule

[11]Yet the group is not so large as to be impracticable. Compare *Eisen* v. *Carlisle & Jacquelin,* 391 F. 2d 555 (2d Cir. 1968) (Eisen II) where the purported class numbers 3,750,000.

23(a)(4). *Eisen* v. *Carlisle & Jacquelin,* 391 F. 2d 555 (2d Cir. 1968) (Eisen II).

Rule 23(a)(3)—requiring that Green's claims be typical of the claims of the class—raises a more complex question. Since Green relies entirely on his purchase of shares after the third prospectus we are presented with the question as to whether he may represent those who purchased before the last prospectus was issued. See *Dolgow* v. *Anderson,* 43 F. R. D. 472, 492 (1968). Because it appears that the faulted misstatements alleged in the first two prospectuses are also present in the third prospectus, it would be logical and efficient to permit Green to represent all the purchasers, at least with respect to the common misrepresentations. Green should be permitted to present the elaborate proof of misstatement, intent, effect on price, and so on, that any purchaser of Wolf's stock between June 1961 and 1963 would need in order to succeed. If the trial court finds at some convenient time that a distinction must be drawn between those who purchased at different times, it is free to make use of the flexibility available to it and so important to the proper application of Rule 23. For example, it may divide the class into subclasses (i.e. those purchasing after issuance of the first prospectus; those purchasing after issuance of the first prospectus and circulation of the second prospectus; and those purchasing after issuance of the first prospectus and circulation of the second and third prospectuses) Rule 23(c)(4), or make such other orders as are necessary, Rule 23(d). Compare *Harris* v. *Jones,* 41 F. R. D. 70 (D. Utah 1966) in which the court concluded it could cope with a class action, although the securities in question had been purchased at different times, under varying circumstances, and in response to separate representations, some oral and some written.

C. *Common Questions*

Thus, the critical issue which emerges here, is whether questions common to the class exist, Rule 23(a)(2), and if so, whether these questions predominate over the individual issues as required by Rule 23(b)(3). As our examination of the genesis of Rule 23 indicates, we approach this question with due respect for the binding effect of a class judgment, but also cognizant of the freedom in the management of the class action given trial courts by that rule. Also, we are not unmindful of the importance of 10b-5 class actions as a weapon against securities fraud and the wisdom of avoiding over-rigidity in blocking such suits.

Green argues that certain misrepresentations and omissions which caused the cash available for distribution to be overstated are common to all three prospectuses. Although it is not feasible to discuss each detail of these alleged misrepresentations without unduly protracting this opinion, it is sufficient for us to state that we agree with the assertion that the misstatements and omissions claimed with regard to the Tidelands Motor Inn account are common to all three prospectuses.[12] Green asserts, *inter alia,* that the prospectuses failed to disclose various *sub rosa* payments made by Joseph Wolf and others to the management of the Tideland Motor Inn to enable the latter to pay its rent to Wolf Corp. Green further claims that the rental payable on the Tidelands property, included by

[12]Wolf argues that the statements of cash available in the first and second prospectuses are mere projections while that in the third prospectus is an actual statement. Hence, it is claimed that there is no common question even if the same misstatements appear in all three. We reject this distinction because the reasonable assumptions on which the projections in the first two prospectuses were made (that the exchange offer would be consummated and that the operation of the properties would continue) are not relevant to the misrepresentations alleged.

Wolf Corp. as an asset in computing the cash available for distribution, was worthless since Tidelands was not generating enough income to pay the rent. The Tidelands rental is a significant part of the total cash claimed by Wolf as available for distribution to shareholders; monetarily it is by far the most significant item in Green's list of misrepresentations. Of a total claimed overstatement of $215,366 in the first prospectus Green attributes $187,000 to the inclusion of the Tidelands rental in the statement of cash available. In the second prospectus, it totals $187,000 of a claimed overstatement of $343,416; and in the third prospectus $225,958 is alleged to be due to Tidelands misstatements, out of a total of $529,146. In sum, since there is a common question with regard to Tidelands, there is a common question with regard to the bulk of Green's allegations.[13]

Every misrepresentation or omission which Green alleges is to be found in the third prospectus. Thus, if Green can prove his case with respect to all the elements of this last prospectus, he will provide all the proof required on the issue of misrepresentation for any other plaintiff, even if the other members of the class purchased their stock before the third prospectus was issued. This too leads us to conclude that common questions of fact and law exist.

In addition, Green's action will set out the complex background common to all those who might have been injured, showing the structure and history of Wolf Corp., the alleged use of the prospectuses to manipulate the price, any proof of intent to manipulate, etc. Moreover, Green argues that Wolf, in making the interrelated misrepresentations in all

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[13]We also find certain sums owing with respect to property at 10 East 40th Street, New York, N. Y. (the Arnold Constable receivable) which Green questions, are common to all three prospectuses. Green claims that misrepresentations were made with respect to this property in each prospectus in the amounts of $28,366, $30,059 and $24,890 respectively.

three prospectuses, engaged in a common course of conduct designed to continually manipulate the market price of Wolf stock. Several courts have satisfied themselves that such a common and consistent course of conduct constitutes a common question under Rule 23. *Dolge* v. *Anderson, supra* at 489; *Fischer* v. *Kletz,* 41 FRD 377, 381 (SDNY 1966) ("Like standing dominoes . . . one misrepresentation in a financial statement can cause subsequent statements to fall into inaccuracy and distortion . . ."). See *Harris* v. *Palm Springs Alpine Estates,* 329 F. 2d 909 (9th Cir. 1964) (decided under the prior Rule 23).

Wolf contends that the prospectuses differ with respect to various minutia and that not all the allegations Green asserts apply to all prospectuses. This may prove to be true, and the differences alleged may even be relevant to the merits of Green's case. But the distinctions are too fine to justify denying a class action at this stage. The district court may use the procedures suggested by Rule 23 to cope with these distinctions, if, indeed, they exist. We shall not attempt either to pre-try or pre-judge all the facets of this case on an appeal from a motion to strike allegations of the complaint. Cf. *Sigel* v. *Chicken Delight,* 271 F. Supp. 722, 726 (N. D. Cal. 1967). The very purpose to be served by a class action is the opportunity it affords to prevent a multiplicity of suits based on a wrong common to all. *Kaplan, supra,* at 390. If we were to deny a class action simply because all of the allegations of the class do not fit together like pieces in a jigsaw puzzle, we would destroy much of the utility of Rule 23.

D. *Predominance of Common Questions*

We find that the common questions predominate over the individual issues involved in this action. The Advisory Committee on Rule 23 noted that

> "... a fraud perpetrated on numerous persons by the use of similar misrepresentations may be an appealing situation for a class action and it may remain so despite the need, if liability is found for a separate determination of the damages suffered by individuals within the class. On the other hand, although showing some common core, a fraud case may be unsuited for treatment as a class action if there was a material variation in the representations made or in the kinds or degrees of reliance by the persons to whom they were addressed." Proposed Amendments to the Rules of Civil Procedure, 39 F. R. D. 69, 103 (1966).

Wolf earnestly argues that each person injured must show that he personally relied on the misrepresentations in order to recover and thus any common issues of misrepresentations do not predominate over the individual questions of reliance. Even if Wolf is correct in its assertion of the need for proof of reliance, and we express no views on that issue, we must still reject the argument. Carried to its logical end, it would negate any attempted class action under Rule 10b-5, since as the District Courts have recognized, reliance is an issue lurking in every 10b-5 action. *Kronenberg* v. *Hotel Governor Clinton Inc.*, 41 F. R. D. 42, 45 (SDNY 1966). We see no sound reason why the trial court, if it determines individual reliance is an essential element of the proof, cannot order separate trials on that particular issue, as on the question of damages, if necessary. The effective administration of 23(b)(3) will often require the use of the "sensible device" of split trials. *Frankel, supra,* 43 F. R. D. at 47.

E. *Superiority of the Class Action*

The last, and in many ways, the most important requirement to be met before this litigation can be allowed to

proceed under Rule 23(b)(3) is that the class action device must be superior to other methods available for a fair and efficient adjudication of the controversy. If a class action is markedly superior to all the alternatives, then, at least at the early stages of the litigation, we should construe broadly the other elements of Rule 23, to permit the efficient enforcement of 10b-5 through class actions with appropriate safeguards. Note, *supra*, 36 Geo. Wash. at 1168. The Court of Appeals for the 7th Circuit has instructed that the relevant question to consider in deciding if a class action is superior to other procedures is the number injured by the alleged violation of 10b-5. *Hohmann* v. *Packard Inst. Co.*, F. 2d , CCH Fed. Sec. L. Rep. ¶ 92,259 at 97,244 (7th Cir., July 17, 1968). Here as many as 2,200 purchasers of Wolf stock might have been harmed, and not one of them seems to have been injured seriously enough to motivate the initiation of a solely individual action.[14]

In sum, we hold that this is a proper case for a class action. We recommend to the district court that it make use of the freedom afforded it by Rule 23 to manage the litigation efficiently and fairly, including the creation of any necessary subclasses. We recognize that this might, in cases such as this, place additional burdens on judges but the alternatives are either no recourse for thousands of

[14]Green also calls to our attention that anyone who now wishes to sue on the basis of the representations in these prospectuses (but Green) would be barred by the Statute of Limitations. This would not, of course, bar those who wish to intervene in this action, see *Escott* v. *Barchris Const. Corp.*; 340 F. 2d 731 (2d Cir. 1965), cert. denied 382 U. S. 816. But to deny a class action under such circumstances would have serious consequences, since all those injured except Green would now have no other remedy, although they may have been relying on Green's class action for their balm. Note that permitting intervention does not necessarily enlarge the period of limitations since the class action relates back to the date of the complaint. *Phila. Elec. Co.* v. *Anaconda Am. Brass Co.*, 43 FRD 452, 461 (ED Pa. 1968).

stockholders to whom the courthouse would thus be out of bounds or a multiplicity and scattering of suits with the inefficient administration of litigation which follows in its wake.[15]

III—Punitive Damages

A. *Appealability*

Green asks us to reverse the District Court's order striking his prayer for punitive damages from the complaint.[16] We question whether such an order would be appealable. *Harvey Aluminum* v. *Longshoremen's Local 8,* 278 F. 2d 63 (9th Cir. 1960). The court's order does not terminate the litigation, as is the case with a denial of the right to

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[15]One further point must be made before we conclude our discussion of class actions. We are aware that one of the most difficult problems raised by the new Rule 23 is the requirement that notice must be sent to every member of the class in a 23(b)(3) action. Rule 23(c)(2). Such notice is expensive and may even cause fluctuations in the price of the stock. Hence, a court in this circuit decided to hold a hearing in order to determine if plaintiff's case is substantial enough to impose the liability of sending this notice on defendants and further if plaintiff should be permitted to proceed with expensive and time-consuming discovery procedures *Dolgow* v. *Anderson, supra.* Another District Court has rejected such a hearing. *Mersay* v. *First Republic Corp.,* 43 F. R. D. 465, 469 (SDNY 1968). This question is not before us now since Green has offered to pay the costs of sending the notice. Nor is there a danger of price fluctuations because the stockholders have already been told the essence of Green's claim in the notice the SEC required Wolf to send each shareholder as part of the consent judgment. Moreover, whatever the merits of such a hearing when ordered by the district court, we believe that, since we hold today that Green may proceed with his action on a class suit basis, any hearing on the sufficiency of his claim would be redundant. We express no opinion, of course, as to whether he states a legally sufficient claim but that issue, and the related discovery questions, would have to be faced by the district court even if Green sued solely in his own behalf.

[16]We, of course, express no opinion as to whether Green has a proper claim for actual damages.

proceed with a class action, *Eisen I, supra,* since the lure of actual damages is adequate to insure vigorous prosecution of the litigation. Moreover, the propriety of the order could be reviewed eventually upon an appeal from a final judgment in the action. Nonetheless, this litigation is properly before us on the class action appeal. And, since our holding on that issue necessarily and inevitably will result in this case going forward in the district court, we believe that we should give the District Court guidance with respect to the punitive damages issue. Such a course will not only minimize the possibility of an expensive and time-consuming retrial of this complicated case, but will result in a more expeditious trial itself. See *Gillespie* v. *U. S. Steel Corp.,* 374 U. S. 148, 153 (1964). Also, it will provide some guide on an appellate level regarding new and important problems of first impression. See *Schlagenhauf* v. *Holder,* 379 U. S. 104, 111 (1964). The issue of punitive damages was carefully considered by the court below and has been fully briefed by both sides on appeal. Accordingly, we have chosen to discuss the question now.

B. *§ 28(a) of the Securities Exchange Act*

Although we find no extensive federal appellate discussion of the problem, several District Courts have examined the issue and have determined that punitive damages may not be recovered in actions under Rule 10b-5 and §10(b) of the 1934 Act because § 28(a) of that act, 15 U. S. C. § 78bb (a), limits recovery in private suits for damages to "actual damages." *Meisel* v. *North Jersey Trust Co.,* 216 F. Supp. 469 (SDNY 1963); *Pappas* v. *Moss,* 257 F. Supp. 345 (D. N. J. 1966), reversed on other grounds 393 F. 2d 865 (1968); Note, Measurement of Damages in Private Actions Under Rule 10b-5, 1968 Wash. U. L. Q. 164. We agree with those conclusions.

Green contends that § 28(a) was intended solely to prevent "double recovery," that is recovering twice for the

same injury by bringing both federal and state law suits. Unfortunately, we find little aid in the legislative history.[17] Thus we must construe the Act to carry out its purpose. See *Gordon* v. *Motel City "B" Associates,* Docket No. 32375 at 60 (2d Cir. decided October 14, 1968). We do not believe that Congress intended the Securities and Exchange Act to be used as a vehicle for the recovery of judgments that could often be grossly disproportionate to the harm done.[18]

It is true that punitive damages are permitted under the Securities Act of 1933, but that Act does not contain language similar to § 28(a) of the 1934 Act. Congress might well have intended to impose different liabilities under each of the two Acts since at the time of its enactment the requirements of the 1934 Act could have been avoided if corporations simply refused to register on the exchanges. The provisions of the 1933 Act were less easily evaded. Hence, lighter penalties under the 1934 Act would have been an inducement for corporations to comply with its terms and not "go on strike," *Globus* v. *Law Research Service,* 287 F. Supp. 188 (SDNY 1968).

Moreover, when the 1934 Act was passed, it was not envisioned that it would provide the basis for so many private actions. Indeed, until *J. I. Case* v. *Borak,* 377 U. S. 926 (1964), no one was sure that private actions could flow from violations of the securities acts. Green's argument

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[17]The principal reference reads, "This subsection reserves rights and remedies existing outside of those provided in the act, but limits the total amount recoverable to the amount of actual damages." H. Rep. No. 1383, 73rd Cong., 2d Sess. (1934) 28.

[18]We cannot ignore entirely huge and perhaps capricious punitive damages which some juries have awarded. E.g., *Butts* v. *Curtis Pub. Co.,* 388 U. S. 130 (1957) ($3 million, reduced by the court to $400,000); *Faulk* v. *Aware Inc.,* 19 App. Div. 2d 464, 244 N. Y. S. 2d 259 (1st Dept. 1963), aff'd mem. 14 N. Y. 2d 899, 200 N. E. 2d 78, 252 N. Y. S. 2d 95 (1964), cert. denied 380 U. S. 916 (1965) ($2.5 million, reduced by the court to $150,000).

that since a cause of action here is only implied, the cause of action should have all the attributes of common law fraud is unfounded. We have gone far beyond the limits of the common law in imposing liability under 10b-5 and thus may not import all the other aspects of common law fraud without scrutiny. See *SEC* v. *Texas Gulf Sulphur Corp.*, Docket No. 30882 (2d Cir. decided August 13, 1968).

C. *Policies of Punitive Damages Not Furthered by Allowing Them Here*

Punitive damages can be justified only as retribution or as a deterrent measure. Restatement, Torts § 908, Comment a; see generally, Note, The Imposition of Punishment by Civil Courts: A Reappraisal of Punitive Damages, 41 N. Y. U. L. Rev. 1159 (1966). The purpose of retribution would not be served by imposing punitive damages for violations of 10b-5 at least as against a publicly held corporation, such as Wolf, because the heavy burden would ultimately fall on all the stockholders, including mere innocent pawns. Thus, some courts have gone so far as to refuse to permit any punitive damages against corporations. Prosser, Torts § 2 at 12 (3d ed. 1964).

Nor are punitive damages needed as a deterrent in this area. In cases such as this it is possible that corporations and even other individuals such as officers, would be subject to crushing liabilities simply on the basis of actual damages because of the cumulative injury that a misstatement concerning widely held stock can cause. As we have discussed in Section II of this opinion, class actions, derivative suits and other such procedural devices provide sufficient incentive to insure that those injured by a violation of 10b-5 will have adequate opportunity to confront alleged malefactors and to have appropriate sanctions imposed upon them. Moreover as an added deterrent the Se-

curities Exchange Act of 1934 contains provisions imposing criminal penalties on violators. 15 U. S. C. § 78ff.

Accordingly, we conclude that punitive damages are not authorized in private actions under § 10(b) and Rule 10b-5.

HAYS, *Circuit Judge* (concurring in part and dissenting in part):

I concur in the court's determination as to the propriety of a class action. I dissent from Part III of Judge Kaufman's opinion on the ground that the issue of punitive damages is not appealable.

APPENDIX B

LEON GREEN etc.

v.

WOLF CORPORATION, et al.

Endorsement

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66 Civ. 3588

All of the defendants have moved for an order pursuant to Rule 23(c)(1), F. R. C. P., determining that this action is not maintainable as a class action, and under Rule 12(f), F. R. C. P., to strike paragraph "2" of the prayer for relief as "impertinent". Although defendant TROSTER, SINGER & Co. has separately moved for this identical relief, we have considered the two motions as jointly made.

This action was filed on October 28, 1966. Plaintiff asserts a claim on behalf of himself, and others similarly situated, under Section 10(b) of the Securities Exchange Act of 1934, as amended, 15 U. S. C. 78j(b) and under Rule 10B-5(2) promulgated by the Commission, 17 C. F. R. Section 240—10b-5(b). In brief, defendants WOLF and others, save TROSTER, SINGER & Co., are charged with violations in connection with the exchange and sale offering of its Class A common stock and debentures in June, 1961, and all defendants are charged in connection with the attempted offering of WOLF stock and debentures pursuant to registration statement filed and later withdrawn, in January 1962.

Let us first examine the background of this action and the identity of the parties involved.

The WOLF CORPORATION was organized in January, 1961, when a group of private individuals who had been dealing in real estate decided to "go public". It acquired

some realty holdings from this group in exchange for subordinated debentures totaling $775,000. On February, 15, 1961, WOLF filed a registration statement (effective June 2, 1961), which later we describe in detail. Following this and on January 26, 1962, WOLF filed a second registration statement, which it amended in June, 1962, and which we have also later described. Because of stop order proceedings before the Commission instituted on September 24, 1962, there were no sales under this registration. It was found by the Commission to be inadequate and deficient and by its order of May 4, 1966, defendant was permitted to withdraw it.

Apparently, plaintiff was one of the earlier investors in some of the properties acquired by WOLF after its incorporation. The complaint alleges that plaintiff had, prior to June, 1961, purchased for $3,500.00 "an interest in a limited partnership which was one of the subjects of the exchange offer covered by the first registration statement." The complaint pleads that, pursuant to this offer, plaintiff exchanged his interest in the said limited partnership for 350 shares of the Class A Common stock and for $777.00 of subordinated debentures of WOLF. Plaintiff was, therefore, not a purchaser of the "public offer" of the registration. The complaint further details plaintiff's dealings in WOLF securities as follows: on June 13, 1962, he purchased 100 Class A Common of WOLF at 10¼; on June 22, 1962, he sold 200 Class A Common (which plaintiff claims he had received as part of the exchange offer) at 10; and on December 16, 1965, he sold 125 Class A Common. (100 shares being, according to plaintiff, the open market purchase, and 25 shares part of the exchange offer) at 1½.

The defendants, other than the WOLF CORPORATION, are: the controlling directors, officers of WOLF—JOSEPH WOLF, JOSEPH ECKHAUS and LEON SPILKY; the accounting firm that certified the financial statements in the prospec-

tuses, DAVID BERDON & Co.; and the broker-dealer who was the prospective underwriter of the second registration statement, TROSTER, SINGER & Co.

We find that the "class" purported to be represented by plaintiff in this action is by the allegations of the complaint (if, indeed, it can be said that thereby any class who has a Section 10b claim under the facts alleged) not one class but two or more; and that the plaintiff cannot be held to be representative of any of these possible groupings of possible plaintiffs.

The complaint recites the filing by WOLF with the Securities and Exchange Commission of two Registration Statements—one statement effective June 2, 1961; and the second statement filed on January 26, 1962 thereafter withdrawn by defendant WOLF pursuant to order of the Securities and Exchange Commission of May 4, 1966.

Although the complaint alleges two Registration Statements, plaintiff's affidavits concern three prospectuses dated June 2, 1961; January 26, 1962 and June, 1962 (copies of which have been submitted.

The prospectus dated June 2, 1961, refers to a Registration filed with the Securities and Exchange Commission under the Securities Act of 1933, as amended, for the registration of 806,350 shares of Class A Common Stock, $3,583,000, Fifteen year 7.2%, Subordinated Debentures due March 10, 1976. The prospectus comprised two offerings. One was an "Exchange offer" by the WOLF CORPORATION of 746,350 shares of Class A Common and $2,808,000 of the subordinated debentures "in exchange for certain of the outstanding interests of certain partners in certain partnerships;" the other was a "Public offer" by the company of 60,000 Class A Common Stock, conditioned upon consummation of the "Exchange" offer.

The prospectus dated January 26, 1962, refers to the Registration filed with the Commission on that day and con-

cerns $4,500,000, 6.5% Convertible Subordinated Debentures, with warrant attached to purchase 450,000 shares of Class A Common, offered "to the holders of its Class A Common", one Right for each unit of 100 of such shares. The company reserved the right to publicly offer the unsubscribed debentures through an underwriter. The underwriter was defendant TROSTER, SINGER & Co., of whom it is said that "the underwriter has had no experience as an underwriter and this offering is its first venture."

The third prospectus of June, 1962 is entitled the "preliminary prospectus dated June 1, 1962"; it is subscribed "underwriter—Troster, Singer & Co." with the notation "The date of this Prospectus is June 1962"; it concerns an offering of $1,321,500—6½% Convertible Debentures and 264,300 Class A Common, offered in units consisting of a debenture, principal amount $250, 50 shares Class A Common, and the debetnures and shares are immediately detachable.

Plaintiff has thus stated his basic contention: WOLF CORPORATION issued three prospectuses "which artificially and falsely inflated the market price of the Corporation's securities by grossly overstating the Corporation's cash available for distribution to stockholders." Plaintiff further contends that this alleged gross overstatement of cash available "artificially and falsely inflated the market price of the subordinated debentures, as well as the market price of the Class A Common stock."

The complaint alleges that both of the Registration Statements included prospectuses with false statements and misleading omissions of material facts. The complaint specifically pleads seven such alleged falsities and omissions as referring to events and facts prior to the filing of the first Registration Statement of June 2, 1961 and nine as referring to events and facts after that date, and which obviously must be found in the second statement of January 26, 1962.

The complaint recites that plaintiff sues on behalf of himself and all monetary purchasers of either the Class A Common Stock or the subordinated debentures of defendant WOLF since June 2, 1961, either in the distribution covered by WOLF's registration statement of that date or thereafter in the open market. Plaintiff's attorney in his deposition and in affidavit submitted on this motion has stated "that the cut-off or terminal date of the period of time commencing on June 2, 1961 was, according to plaintiff, the end of 1963."

That the class plaintiff would represent in this action is in fact two separate groupings, appears evident. The allegations of the complaint, if accepted as fact, define one group or class as those who purchased securities of WOLF from and after the filing of the first statement up to the filing and publication of the second registration of January 26, 1962, and who did not sell them until later at a loss because of reliance on either of the two alleged false statements. It defines another group or class as those who purchased WOLF securities after January 26, 1962 and did not sell them until after the alleged manipulation of prices had no longer been effective—apparently, now stated to be the end of 1963. The complaint alleges no claim against the underwriters, TROSTER, SINGER & Co., save those which are founded on purchases made between January 26, 1962 and December 31, 1963.

It is not in dispute that plaintiff was a purchaser of Class A Common stock and of a debenture of WOLF. It appears uncontradicted that approximately 1200 persons hold the common stock of the WOLF CORPORATION and approximately 1000 persons hold debentures of the corporation. No other purchaser or holder of WOLF securities has joined plaintiff in this action. The fraudulent actions charged are alleged to have been committed over five years ago. With a single plaintiff and no other complaining or

intervening party, the Court is not presented with a number of suits seeking to enforce similar claims. In this action, orderly judicial administration does not call for the maintenance of a class action. We are not confronted with problems of duplication of discovery, either by way of inspection, interrogatories or depositions, either in this Court or in other forums.

Although this reason alone is sufficient to preclude class treatment, the other essential elements are also lacking. Thus, the monetary loss to the plaintiff is alleged (in an affidavit of counsel) to be less than $1,000, a minute figure which is not explained or related to the defendant's activities. Plaintiff does not allege any damages in his complaint; he just states that he bought and sold his stock at a certain price, and that defendants misrepresented by overstatement of their cash position. The claimed loss, compared with the possible figure of loss to the class he would represent, certainly affects the adequacy of his representation. In addition, he is but one stockholder out of a potential class of more than 2,000 if, as he alleges, he represents purchasers over a period of two years. He has also failed to show any common questions of fact or law, common to himself and the members of the class he would represent. Thus, while he alleges reliance on the 1961 and January, 1962 statements, he purports to represent a class which purchased during the next two years "in reliance on the 1961 statement" as well apparently as in reliance on a subsequent statement, that of June, 1962, which never issued and which was not circulated to the purchasing public—the only class which plaintiff claims to represent. In addition, when he first purchased under the "Exchange offer", he was not a member of the public, but a member of a specific segment to whom the 1961 exchange offering was addressed. Since plaintiff alleges three prospectuses, it appears that he is attempting to represent three distinct classes, which are not

in any way defined, which he lumps together for a period of two years, and which, if he could define and separate, he could not adequately represent.

Defendants have not sought, nor do they now desire, the protection against other actions which would be afforded by a Rule 23 bar order.

Reasons of judicial functioning and the interest of other stockholders and owners of debentures under these circumstances, support the granting of the relief sought by the defendants. To declare this a class action would not only impose upon the defendants the unnecessary expense of giving a large number of investors in WOLF due notice by advertising and mail of the pendency of this suit, but the receipt of such notice sent by Court direction might well have the effect of advertising for the filing of suits of intervention in this pending suit by stockholders who, up to this late date, have shown no interest or desire to do and when, in fact, they may have no just claim to assert.

It is not the purpose of Rule 23 to promote, induce or encourage mass participation litigation by judicial invitation, particularly where the facts presented do not clearly indicate that justice requires it. We find no need to apply its provisions to this suit, save to declare that this suit is not to be maintained as a class action.

The motion to strike the prayer for punitive damages is granted. Where statutory damages are provided, a plaintiff is limited to those damages; Section #78bb provides that the only damages recoverable are "actual" damages. Meisel v. No. Jersey Trust Co., 216 F. Supp. 469 (S.D.N.Y., 1963).

Motions granted; settle order on 5 days' notice; so ordered.

Dated: February 21, 1968.

/s/ SYLVESTER J. RYAN
U.S.D.J.